The Evolution of Fraud on the Market Suits and Halliburton II

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Professor Merritt B. Fox
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Overview

- **Nature of Fraud-on-the-market (FOM) Suits as an Economic Phenomenon**
- **Social Consequences of FOM Suits**
- **Legal Development of the Doctrine**
- **Halliburton II**
FOM actions are private damage actions that allow securities buyers in secondary trading markets to recover losses incurred from purchasing at prices inflated by misstatements of the issuing firm made with scienter.

- FOM actions represent the vast bulk of all private securities actions in terms of settlements and damage judgments.
  - what gives the U.S. the reputation of having securities litigation gone wild.
Justifications

• Compensatory justification, though often offered, is weak

• Improving transparency by deterring misstatements is much stronger:
  – enhances corporate governance
  – increases liquidity
Weakness of Compensatory Rationale For FOM Liability

• Compensation not needed to correct for *ex ante* unfairness:
  – a misstatement having a positive effect on prices has a neutral effect on an investor’s expected trading profits.

• Compensation not needed to correct for *ex post* unfairness:
  – circular, or
  – just moves the unfairness to other equally innocent investors

• Costly and only weakly effective way to improve allocation of risk
Corporate Governance Arguments For FOM Liability

- Deterring misstatements is especially effective in enhancing transparency in a system with extensive mandatory disclosure requirements
  - creates less concern with general deterrence working in opposite direction of specific deterrence

- FOM actions can be seen as a mandatory disclosure private enforcement mechanism
Enhancing *Legal* Controls on Management

- Assists effectiveness of *shareholder franchise*
- Assists effectiveness of *shareholder enforcement* of management’s fiduciary duties
Enhancing Market Controls on Management

• Increases the threat of *hostile takeover* when managers engage in non-share-value-maximizing behavior

  – makes a takeover less risky for potential acquirers

  – reduces the chance that a value-enhancing acquisition will be deterred by the target having an inaccurately high share price
Enhancing Market Controls on Management- Cont’d

- Increases the use and effectiveness of share price based management compensation by:
  
  - reducing the riskiness associated with holding an issuer’s stock in a less than fully diversified portfolio

  - making share-price-based management compensation more accurate incentive
Enhancing Liquidity Arguments for FOM Liability

- More transparency reduces information asymmetries between insiders and outsiders

- Market makers and other sources of liquidity are consequently less afraid of being a counterparty to a transaction with someone with inside information

- The bid/ask spread, which exists in significant part to protect against this risk, will become smaller, thereby increasing liquidity
Ideal Incidence of Liability If Misstatement’s Price Impact Could be Precisely Determined

- Social gains from deterring misstatements are likely proportional to the extent that they distort prices

- Social costs from imposing liability closer to being fixed regardless of the extent of distortion

- Ideally liability should only be imposed:
  - when misstatement actually distorted price, and
  - when the distortion is great enough that the social gains exceed the social costs - a level we could call the “importance threshold”
Impact of Misstatement on Price in Reality Cannot be Determined with Precision

- Misstatement most often designed to falsely maintain current expectations
  - actual impact is avoiding the decline in price that a truthful statement or perhaps even no statement would cause

- Leads to focus instead on the actual impact of the issuer’s “corrective disclosure”

- Actual impact of corrective disclosure itself cannot be determined with precision

- Price impacted by many other bits of information at the same time
  - bits relevant to assessing future cash flows market-wide
  - firm specific bits relevant to assessing just the issuer’s future cash flows other than the corrective disclosure
Event Studies Attempt to Isolate Out Price Impact, If Any, of a Corrective Disclosure

- **First**, find market-adjusted price change, thereby eliminating impact of market-wide bits, the source of systemic volatility

- **Second**, compare this to past market-adjusted prices to calculate the *probability* that it was caused *entirely* by unsystematic bits other than the corrective disclosure, i.e. corrective disclosure had no price impact
  - courts generally grant defs summary judgment if plaintiffs are unable to introduce expert testimony based on a plausibly constructed event study rejecting with 95% confidence null hypothesis that the observed market-adjusted price change was caused *solely* by ordinary unsystematic news
  - satisfied by a negative market-adjusted price change $>1.96$ standard deviations based on past market adjusted changes (i.e. record of past idiosyncratic volatility)
Isolation of Firm-Specific News Through Market-Adjustment

Market-adjusted price change = $2.00 (price impact of all firm-specific news, including the impact, if any, of the corrective disclosure)

Market adjustment = 1.5 x (- .01) x $100.00
= -$1.50

FIGURE 1.
Demonstration That With an Observed Market Price of $96.50 The Corrective Disclosure Will Have Had No Impact on Price Less than 2 ½ Percent of the Time

The mean of the distribution of the impact of firm-specific news other than the corrective disclosure will equal zero. So, if the corrective disclosure has no impact on price, the mean of the distribution of possible observed market-adjusted prices equals $98.50. The impact of firm-specific news other than the corrective disclosure will be more negative by more than $1.96 (1.96 standard deviations) no more than 2½ percent of the time. This means that when the impact of the corrective disclosure is zero, there is less than a 2½ percent chance that the observed price will be below $96.54. $96.50 is below $96.54.
Type I Error Associated With an Event Study Using a 95% Standard

- **Type I Error**: a corrective disclosure that in fact has no negative impact on price is falsely identified as having an impact on price (“false positive”)

- Will occur no more than 2 ½ % of the time with this standard

- Type I Error is **undesirable** because it triggers the socially costly imposition of liability where there is no social gain
Type II Error Associated With an Event Study Using a 95% Standard

- **Type II Error**: a corrective disclosure that in fact has a negative impact on price that is falsely identified as having no impact on price (a “false negative”)

- Rate of occurrence is
  - inversely related to how negative the actual impact on price is
  - positively related to the size of the standard error

- In the example, if the actual impact were
  - -1.00%, the Type II error would be 83%
  - -2.00%, the Type II error rate declines to slightly below 50%

- For a company with a standard deviation of the average company in normal times, if the actual impact were -5.00%, the Type II error rate would be about 20%
Demonstration That With a Corrective Disclosure Having an Actual Negative Impact of $1.00, the Observed Market Price Will Be Negative Enough to Be Considered Statistically Significant Only One Time in Six

The mean of the distribution of the impact of firm-specific news other than the corrective disclosure will equal zero. So, if the corrective disclosure has a $1.00 negative impact on price, the mean of the distribution of possible observed market-adjusted prices would equal $97.50. The observed market-adjusted price must be at or below $96.54 to be considered statistically significant at the 95 percent level. The impact of firm-specific news other than the corrective disclosure will therefore need to negative $.96 or more (.96 standard deviations) for the observed market-adjusted price to be at or below $96.54. This will occur only about 17 percent of the time, which is about on time in six.
Type II Error would be:

- **Undesirable** for disclosures with actual negative impacts large enough to suggest that the misstatement meets the importance threshold

- **Desirable** with respect to disclosures with less negative actual impacts
Fraud Actions Before Basic: The Traditional Reliance Requirement

• Typically involved a misstatement in a face-to-face transaction in shares of a non-public issuer or in an IPO

• Plaintiff needed to establish “reliance”
  – i.e. the misstatement was a “but for” cause of the plaintiff making a purchase that subsequently declined in price (*List v. Fashion Park*)

• Later became known also as the transaction causation requirement

• Made class actions impossible because the individual proof needed to meet the reliance requirement meant that common issues of fact and law did not predominate
Traditional Reliance Based Cases: Loss Causation

• As case law developed, an additional requirement became clear: *loss causation*.

• Plaintiff must show:
  – the purchased security declined in value from what was paid (or what was sold at a loss)
  – the decline or loss was in some way reasonably related to the falsity of the statement that induced the purchase
The Basic Revolution

• In 1988, Supreme Court decided Basic v. Levinson, where it endorsed the FOM theory that had been developing in the lower courts

• Where the plaintiff could establish (a) that issuer publicly made a material misstatement, and (b) that its shares traded in an efficient market, there is a presumption that the reliance requirement has been met
  — rhetorically based on somewhat incoherent rationale that plaintiff “relied on the integrity of the market”

• Made class actions possible
  — Presumption could be established for the class without individual showings
  — opened the floodgates: economies of scale in securities litigation usually made individual actions based on a corporate misstatement impractical
Court did provide a more coherent rationale related to causation.

Court said that for transactions in efficient, public secondary markets, FOM theory provides

“an alternative way to demonstrate requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury”

• A showing that the misstatement caused the price the plaintiff paid at time of purchase to be too high
Differences in Causation: Traditional Reliance Cases

Legal rhetoric aside, causation in FOM and traditional reliance are different.

Plaintiff in a traditional reliance based action needs to show that she would have acted differently but for the wrongful misstatement.

- At a minimum, plaintiff must have been aware of the misstatement.
Differences in Causation: FOM Cases

Plaintiff in FOM case, typically a portfolio investor making impersonal purchases on the NYSE or NASDAQ, may well have purchased even if the statement had not been made

- certainly true if plaintiff not aware of the statement
- often true even if she were aware: the stock would be less attractive but it would sell for a commensurately lower price
Analytically, Three Elements Are Necessary For FOM Action

• The misstatement must *inflate* the market price of the security at the time of the plaintiff’s purchase

• The investor must purchase the security at the inflated price

• The investor must not resell the security sufficiently quickly that the price at the time of sale is still equally inflated, in which case she would suffer no loss from paying too much
A plaintiff cannot establish causation, what the Court calls “loss causation”, *merely* by pleading and proving that the misstatement inflated the price.

Lower courts found that the needed “something more” to be a market-adjusted priced drop at the time of the corrective disclosure satisfying the 95% standard.

- really shows the initial inflation
- efficient market tells us that if the truth is out, inflation is gone so there is a loss.
Court in *Basic* said the presumption was rebuttable, with one of the grounds being that the price was not affected by the misrepresentation.

Halliburton argued that the presumption was necessary for the suit against it to proceed on a class basis, and therefore it should be entitled to rebut the presumption at the class certification hearing by showing no impact on price.

Catching more attention in advance of the Court’s decision, Halliburton also argued the FOM action should be eliminated because developments in financial economics since 1988 show that *Basic*’s premises— the Efficient Market Hypothesis—to be outmoded and because experience has shown the policy considerations driving *Basic* to have been misguided.
Justice Roberts’ Opinion in Halliburton II

Rejected the frontal assault on the FOM that caught so much attention

Accepted Halliburton argument concerning the right of rebuttal at class certification hearing:

“Defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.”

• Left open the question of what the standard is for determining whether the evidence presented is sufficient to rebut the presumption
Two Approaches to What Defs Must Show

• **Approach I:** Impose the same statistical burden on defendants seeking to show there was *no* price effect as is currently imposed on plaintiffs, at the loss causation stage of litigation, to show that there *was* a price effect.

• **Approach II:** Only require defendant to persuade the court that the plaintiff will not be able to meet the plaintiffs’ statistical burden concerning price effect when they are later called upon to demonstrate loss causation.
Approach I
The same statistical burden as put on plaintiffs would require an event study with a positive market-adjusted price change of at least 1.96 standard deviations.

Demonstration That With an Observed Market Price of $100.50 The Corrective Disclosure Will Have Had a Negative Impact on Price Less Than 2½ Percent of the Time

The mean of the distribution of the impact of firm-specific news other than the corrective disclosure will equal zero. So, if the corrective disclosure has just a slight negative impact on price ($0.01), the mean of the distribution of possible observed market-adjusted prices equals $98.49. The impact of firm-specific news other than the corrective disclosure will be positive by $1.96 or more (1.96 standard deviations) no more than 2½ percent of the time. This means that when the impact of the corrective disclosure is -$0.01, there is less than a 2½ percent chance that the observed price will be above $100.45. $100.50 is above $100.45. If the impact of the corrective disclosure were more negative than $0.01, the likelihood that the observed market-adjusted price would be $100.50 would be even less.
Defendant to introduce expert testimony based on an event study of the corrective disclosure that shows a market-adjusted price change that is not negative enough (if it is negative at all) to meet the 95% confidence standard.

Then plaintiffs introduce their own event-study-based expert testimony.

- If the plaintiffs’ event study also fails to show a market-adjusted price change negative enough to meet the standard, defendant’s rebuttal will be successful.
- If plaintiffs’ study does show a change sufficiently negative, but the court is not persuaded that the plaintiffs’ testimony is more persuasive than the defendant’s, defendant’s rebuttal will also be successful.

If rebuttal succeeds, action cannot proceed on a class basis and will probably end

- same result as would have occurred, pre-Halliburton II, with regard to loss causation *later* at the merits stage of the litigation.
Consequences of the Choice

**Approach I:** Halliburton II is unlikely to have much effect on the cases that are brought or on their resolution by settlement or adjudication

- any case where now a defendant could successfully rebut the presumption would, before, either not have been brought or not survive the motion to dismiss

**Approach II:** Some cases that before would have been brought and survived the motion to dismiss will be ended before, rather than after, the expensive discovery stage
Considerations in Favor of Approach I

Takes Court at its word as to what the inquiry at the class certification stage should be about – no effect on price – and fairly applies the same statistical burden to both sides

• potentially high Type II error rate shows that a failure by plaintiffs to meet their burden (the test in the Approach II) is not equivalent to showing that it is likely there was no effect on price

Consistent with what Court said in Halliburton I

• plaintiff not required to establish loss causation to obtain class certification
Considerations in Favor of Approach II

Policy considerations: if one believes that currently too many fraud-on-the-market suits make it to the highly expensive discovery stage

• second approach reduces the social costs associated with allowing fraud-on-the-market litigations by weeding out cases early that ultimately would not succeed in any event

Precedent: this is the way at least one court approached the same question in the past
Other Considerations Arising From Asking Why Is the Burden On Plaintiffs So Heavy Anyway

Normal rule in civil cases is preponderance of the evidence, i.e. evidence must just show that the chance are better than 50-50 that what the moving party asserts is in fact correct.

Possible reasons:

- **unthinking application of scientific standard** - might require revising the standard but not an argument to impose a different standard on defendants than on plaintiffs.
- **compensating for bias of experts** - also would not be an argument to impose a different standard on defendants than on plaintiffs.
- **using the test as a screen for the importance of the misstatement, not just for misstatements that have no effect on price** - would call for a lower statistical burden to be imposed on defendants than on plaintiffs.